

April 04, 2006

GLORIA L. FRANKLIN, CLERK
U.S. BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA



Signed: April 04, 2006

DO NOT PUBLISH

EDWARD D. JELLEN
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

In re

No. 04-45127

Adv. No. 05-4223

ZAHID CHAUDHRY,

Debtor. /

LOIS I. BRADY,

Plaintiff,

vs.

AREENA R. CHAUDHRY,

Defendant. /

DECISION

This is an adversary proceeding in which the plaintiff, Lois I. Brady ("Brady"), trustee in bankruptcy of the estate of Zahid Chaudhry (the "debtor"), seeks relief against defendant Areena R. Chaudhry ("Chaudhry") in connection with an alleged debt Chaudhry owed to the debtor at the date of the debtor's chapter 7 petition. The alleged debt is for the unpaid portion of the purchase price of real property that the debtor sold to Chaudhry as part of a sale and leaseback transaction.

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Decision

1 The parties have filed cross-motions for summary judgment. The
2 court will grant Chaudhry's motion and deny Brady's motion.

3 A. Background

4 The material facts are undisputed. On September 30, 2003, the
5 debtor and his spouse, Bushra S. Chaudhry, entered into a written
6 Sales Agreement (the "Sales Agreement") with Chaudhry pursuant to
7 which Chaudhry agreed to purchase certain real property in Hayward,
8 California (the "Property") from the debtor and his spouse¹ for a
9 purchase price of \$370,000. Chaudhry agreed to pay the major
10 portion of the purchase price through the assumption of a \$268,000
11 loan that was secured by the Property. As to the balance, the Sales
12 Agreement provided as follows:

13 The sellers will rent that aforementioned property for an
14 amount of \$1,500 per month. The rent will be deducted
15 from their equity until the equity is depleted. The
sellers and the buyer can, at that time, negotiate another
lease agreement at the current market rate.

16 If the sellers decide not to reside in the aforementioned
17 property the sellers' remaining equity will be paid no
later than December 31, 2010.

18 Thus, Chaudhry was to pay the remainder of the purchase price
19 through a monthly \$1,500 credit in reduction of the outstanding
20 balance she owed, which monthly credits were to continue as long as
21 the debtor desired to remain in the Property. If, however, the
22

23 ¹Bushra S. Chaudhry's participation with the debtor as a
24 co-seller and co-lessee under the Sales Agreement is not relevant
25 to the motions now before the court. Therefore, for purposes of
26 clarity, the court will hereafter disregard Bushra S. Chaudhry's
participation as a party to the Sales Agreement.

1 debtor decided to vacate the Property, the balance of the purchase
2 price would be due by December 31, 2010.

3 The debtor filed his chapter 7 petition on September 20, 2004.
4 At that date, the remaining balance of the purchase price was
5 \$35,637. This amount represents the original purchase price, less
6 credits for the loan payments Chaudhry made, less 12 monthly rent
7 credits totaling \$18,000.

8 After the petition, the debtor continued to reside in the
9 Property. Brady made demand on Chaudhry for payment of \$35,637 and
10 Chaudhry denied liability. Brady then filed this adversary
11 proceeding.

12 B. Discussion

13 1. Summary Judgment

14 "Summary judgment is properly granted when there is no genuine
15 issue of material fact and moving party is entitled to judgment as a
16 matter of law." Clipper Express v. Rocky Mountain Motor Tariff
17 Bureau, Inc., 690 F.2d 1240, 1250 (9th Cir. 1982), cert. denied, 459
18 U.S. 1227 (1983). Under Fed. R. Bankr. P. 7056, which incorporates
19 Fed. R. Civ. P. 56, the court may grant summary judgment or partial
20 summary judgment if there is no genuine issue of material fact, and
21 the movant is entitled to the requested judgment as a matter of law.

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1 2. Contentions of the Parties

2 Brady raises two basic arguments in support of her position.
3 First, Brady argues that pursuant to Bankruptcy Code § 541(a),² the
4 debt that Chaudhry owed to the debtor became property of the
5 bankruptcy estate at the time of the bankruptcy filing. It follows,
6 argues Brady, that as of the petition date, Chaudhry was obliged
7 pursuant to § 542(a)³ to "deliver" the purchase price to her.

8 Alternatively, Brady argues that Chaudhry is obligated pursuant
9 to § 542(b)⁴ to pay a debt of \$35,637 to her (conceding, however,
10 that such payment is not due until December 31, 2010). In this
11 regard, Brady contends that Chaudhry is not entitled to offset any

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13 ²All further section references herein are to the Bankruptcy
14 Code, as in effect prior to October 17, 2005.

15 ³Section 542(a) provides:

16 Except as provided in subsection (c) or (d) of this section,
17 an entity, other than a custodian, in possession, custody, or
18 control, during the case, of property that the trustee may use,
19 sell, or lease under section 363 of this title, or that the
20 debtor may exempt under section 522 of this title, shall deliver
21 to the trustee, and account for, such property or the value of
22 such property, unless such property is of inconsequential value
23 or benefit to the estate.

24 ⁴Section 542(b) provides:

25 Except as provided in subsection (c) or (d) of this section,
26 an entity that owes a debt that is property of the estate and
27 that is matured, payable on demand, or payable on order shall pay
28 such debt to, or on the order of, the trustee, except to the
29 extent that such debt may be offset under section 553 of this
30 title against a claim against the debtor.

1 postpetition rent against the debt pursuant to § 553. This is so,
2 argues Brady, because the requisite "mutuality" is lacking due to
3 the fact that Chaudhry's debt to the debtor arose prepetition
4 whereas the debtor's debt for rent that accrued after the bankruptcy
5 filing was a postpetition debt.

6 Chaudhry concedes that, under § 541(a), her debt to the debtor
7 became property of the debtor's bankruptcy estate. Chaudhry argues,
8 however, that even if the doctrine of mutuality bars offset of the
9 postpetition rent against the purchase price, the doctrine of
10 "recoupment" permits deduction of the monthly rent from the balance
11 of the purchase price for so long as the debtor remains in
12 possession of the Property, and to the extent any funds remain owing
13 after the debtor vacates, such funds will not be due until December
14 31, 2010. In response, Brady argues that recoupment does not apply,
15 and in any event, that Chaudhry waived her right to argue
16 recoupment.

17 The court holds that: (a) Chaudhry is not obligated to
18 "deliver" the balance of the purchase price to Brady pursuant to
19 § 542(a), (b) Chaudhry's obligation to pay Brady under § 542(b) is
20 subject to recoupment, (c) under the undisputed facts of this case,
21 Chaudhry's debt to the debtor, and thus her debt to Brady, has been
22 eliminated to the extent of any postpetition rent during any period
23 the debtor occupied the Property, and that (c) any remaining unpaid
24 balance will not be payable by Chaudhry until December 31, 2010.

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1 3. Turnover and § 542(a)

2 It is clear that § 542(a) is inapplicable in a situation, as
3 here, where a trustee seeks a money judgment for an alleged debt.
4 Otherwise, § 542(b), which deals specifically with the trustee's
5 collection of debts owed to the debtor, would be superfluous.
6 Moreover, as noted by Chaudhry, the case law is consistent that
7 § 542(a) does not apply absent a res consisting of identifiable
8 property or proceeds. See, e.g., In re Sun Spas by Schaeffer, Inc.,
9 122 B.R. 452, 455 (Bankr. M.D. Fla. 1990); In re Gailey, Inc., 119
10 B.R. 504, 514 (Bankr. W.D. Pa. 1990). See also Maggio v. Zeitz, 333
11 U.S. 56, 64 (1948) (pre-code).

12 Here, there is no res of identifiable property or proceeds.
13 The court therefore holds that Chaudhry is entitled to summary
14 judgment as to Brady's claims based on § 542(a).

15 4. Recoupment and § 542(b)

16 In their briefs, the parties initially directed their arguments
17 to the portion of § 542(b) that allows offset under § 553. Chaudhry
18 has now re-focused her argument on the doctrine of recoupment.
19 Because the court believes recoupment is available here, it will
20 forgo discussion of the setoff arguments the parties initially
21 advanced.

22 The requirements for recoupment and setoff are not the same.
23 In general, setoff is available when entities owe each other money
24 on their respective debts to each other. See Citizens Bank of
25 Maryland v. Strumpf, 116 S.Ct. 286, 289 (1995). "The defining
26 characteristic of setoff is that 'the mutual debt and claim . . .

1 are generally those arising from different transactions.'" Newbery
2 Corp. v. Fireman's Fund Ins. Co., 95 F.3d 1392, 1398 (9th Cir. 1996)
3 (internal citation omitted; emphasis in the original); In re TLC
4 Hospitals, Inc., 224 F.3d 1008, 1011 (9th Cir. 2000).

5 In contrast, "recoupment 'is the setting up of a demand arising
6 from the same transaction as the plaintiff's claim or cause of
7 action, strictly for purposes of abatement or reduction of such
8 claim.'" Newbery, 95 F.3d at 1399 (internal citation omitted;
9 emphasis in the original). As the court in Newbery explained,
10 recoupment is not subject to the automatic stay under § 362(a), nor
11 is it subject to any limitations imposed by § 553. Id. Moreover,
12 recoupment "'relaxes the requirement of mutuality for setoff of
13 debts as it relates to the pre or postpetition character of those
14 debts.'" Id. (Internal citation omitted.)

15 A bankruptcy trustee takes property subject to rights of
16 recoupment. In re Madigan, 270 B.R. 749, 754 (9th Cir. BAP 2001);
17 In re Flagstaff Realty Assocs., 60 F.3d 1031, 1035 (3d Cir. 1995).

18 To determine whether recoupment is available, courts have asked
19 whether the claim "arises out of the transaction or occurrence that
20 is the subject matter of the opposing party's claim." Fed. R. Civ.
21 P. 13(a); Madigan, 270 B.R. at 755. As the court in Madigan noted,
22 "'courts have permitted a variety of obligations to be recouped
23 against each other, requiring only that the obligations be
24 sufficiently interconnected so that it would be unjust to insist
25 that one party fulfill its obligation without requiring the same of
26 the other party.'" Id. (Internal citation omitted.)

1 Here, recoupment is available to Chaudhry. As reflected by the
2 Sales Agreement, the sale to Chaudhry and the leaseback to the
3 debtor were integrated obligations under a single agreement.
4 Chaudhry was not obligated under the Sales Agreement to make any
5 payments to the debtor so long as the debtor occupied the Property.
6 The debtor was not obligated to make any rent payments to Chaudhry
7 so long as a balance was owing on the purchase price. (Per the
8 Sales Agreement, "[T]he rent will be deducted from . . . equity
9 until the equity is depleted.")

10 Brady argues that denial of Chaudhry's right of recoupment
11 would not be inequitable to Chaudhry because she should have evicted
12 the debtor upon the bankruptcy filing and relet the Property. If
13 Chaudhry had done so, argues Brady, Chaudhry would not be in the
14 position of owing the balance of the purchase price as of the
15 petition date to Brady, and yet not being able to recover any rent
16 from the debtor. (As of the petition date, the Sales Agreement did
17 not require the debtor to pay any rent except as credits against the
18 purchase price.) But, as Chaudhry notes, the debtor was not in
19 default under the Sales Agreement at the date of the petition, and
20 the theory on which Chaudhry would have effected such an eviction is
21 problematic.

22 Brady argues that recoupment is not available because the sale
23 and leaseback were two separate transactions. For the reasons
24 stated above, the court disagrees. Under the Sales Agreement, one
25 integrated transaction was involved, the netting provisions of which
26 - rent against purchase price - were central to the deal from the

1 standpoint of both parties.

2 Brady also argues that Chaudhry waived the right to argue
3 recoupment because her answer to the complaint, as initially filed,
4 did not mention recoupment.

5 This argument fails. On June 24, 2005, Chaudhry, acting
6 without benefit of counsel, wrote a letter to the court stating that
7 she intended the letter to be her response to the complaint. The
8 letter described the parties' obligations under the Sales Agreement
9 and emphasized that the rent payments were to be deducted from the
10 purchase price. Although Chaudhry did not use the word
11 "recoupment," her allegations in response to the complaint were
12 specific and clear, and certainly sufficient to put Brady on notice
13 of her factual contentions and to put recoupment at issue. See Fed.
14 R. Civ. P. 8(c), 8(e)(1), and 8(f), applicable via Fed. R. Bankr. P.
15 7008.⁵

16 In addition, on August 12, 2005, after employing counsel,
17 Chaudhry filed an amended answer setting forth various affirmative
18 defenses. The second affirmative defense stated: "Plaintiff's
19 claims are barred by the doctrines of setoff and recoupment."
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21 ⁵Fed. R. Civ. P. 8(c) provides, in part: "When a party has
22 mistakenly designated a defense as a counterclaim or a
23 counterclaim as defense, the court on terms, if justice so
24 requires, shall treat the pleading as if there had been a proper
25 designation." Fed. R. Civ. P. 8(e)(1) provides: "Each averment
26 of a pleading shall be simple, concise, and direct. No technical
forms of pleading or motions is required." Fed. R. Civ. P. 8(f)
provides: "All pleadings shall be so construed as to do
substantial justice."

1 On November 22, 2005, this court entered its Order Setting
2 Aside Default and Default Judgment. Paragraph 2 of that order
3 provided that the above referenced letter would be deemed as an
4 answer to the complaint. Paragraph 3 of the order provided: "The
5 Answer to Complaint filed by Plaintiff on August 12, 2005 is hereby
6 deemed an amended answer."

7 The court holds that Chaudhry did not waive her right to assert
8 recoupment against Brady.

9 C. Conclusion

10 The court will grant Chaudhry's motion for summary judgment and
11 deny Brady's motion for summary judgment. The court requests
12 Chaudhry to submit a proposed order so providing within 15 days. It
13 appears to the court that no further issues remain. If so, Chaudhry
14 may also submit a proposed judgment on the merits (the parties to
15 bear their own costs).

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17 **END OF ORDER**
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Decision

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